No. 10240

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

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Jurisdiction.

This petition for review involves deficiencies in Federal corporation income taxes for the years 1936, 1937 and 1938 in the total amount of $991.05 and deficiencies in Federal personal holding company surtaxes for the years 1937 and 1938 totaling $15,255.36. [Tr. 31.] The decision of the United States Board of Tax Appeals (now designated as the Tax Court of the United States and hereinafter referred to as the "Tax Court") fixing said deficiency was entered May 12, 1942. [Tr. 46.] This petition for review was filed August 6, 1942 [Tr. 150] pursuant to the provisions of Section 1142 of the Internal Revenue Code, 26 U. S. C. A. §§1140-1142 (1940).

Opinion Below.

The only previous opinion rendered in this cause is the memorandum opinion [unreported, Tr. 41-46] of the Tax Court.

Issues Involved.

(1) Is petitioner entitled to deduct in determining its net taxable income for the calendar years 1936, 1937 and 1938 the salary paid by it during said years to its president, Douglas W. Wilson.

(2) Under the circumstances here involved, is petitioner liable for personal holding company surtaxes for the years 1937 and 1938 in view of the fact that all of its income for said years was distributed either as dividends or salaries, and was duly tax paid by the recipients thereof.

A third question was raised before the Tax Court and related to the deductibility of a loss sustained by petitioner in connection with a bond issued by the Breakers Hotel. This issue was decided against petitioner by the Tax Court, but the decision with respect thereto is not before this Court for review.

Statutes and Regulations Involved.

(1) Salary Issue.

(a) Section 23 of the Revenue Acts of 1936 and 1938 provides in part as follows:

"Deductions From Gross Income.

In computing net income, there shall be allowed as deductions:

(a) Expenses.—

(1) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *"

(b) Article 23(a)-6 of Regulations 94 and 101 issued under the Revenue Acts of 1936 and 1938 respectively provides in part as follows:

"Compensation for personal services.—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered * * *"

(2) Personal Holding Company Surtax Issue.

(a) Section 351 of the Revenue Act of 1937 provides in part as follows:

"There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of $2,000; plus

(2) 75 per centum of the amount thereof in excess of $2,000."

(b) Section 401 of the Revenue Act of 1938 provides in part as follows:

"There shall be levied, collected, and paid, for each taxable year, upon the undistributed Title IA net income of every personal holding company (in addition to the taxes imposed by Title I) a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of $2,000; plus

(2) 75 per centum of the amount thereof in excess of $2,000."

Statement of Facts.

This proceeding was submitted to the Tax Court on the pleadings, the deposition of Douglas W. Wilson [Tr. 53-90], and certain exhibits containing pertinent statistical data introduced in evidence at the hearing. *The respondent introduced no evidence.*

Because of its importance, the testimony of petitioner's witness, Douglas W. Wilson, is printed in full in the transcript of record, pages 53-90.

The facts here involved are simple and may be summarized as follows:

(1) In 1893 one Warren Wilson acquired an unincorporated business operating in Los Angeles, California and called the Daily Journal Company which published a legal newspaper named the "Los Angeles Daily Journal." [Tr. 54, 55.] In 1895 this enterprise was incorporated under the name of Daily Journal Company, a California corporation, the petitioner herein. [Tr. 55.]

Warren Wilson was petitioner's president from its incorporation until the former's death in 1917. [Tr. 55.] At his death, and for some time prior thereto, Wilson received an annual salary of $24,000.00 as petitioner's president. [Tr. 58.]

(2) In 1906, Douglas W. Wilson, Warren Wilson's son, entered the employ of petitioner as its circulation manager. [Tr. 54, 55.] In 1912, he became Vice-president and Assistant Manager. In 1917, upon his father's death, Douglas W. Wilson became petitioner's president, and has continued as such continuously to the present. [Tr. 56, 57.]

Since 1917, Douglas W. Wilson has devoted all his time to the management of petitioner's affairs [Tr. 57], and pursuant to appropriate corporate resolution has received from petitioner as president an annual salary of $12,000.00. [Tr. 57, 58.]

(3) Between 1917 and 1929, petitioner's business more than doubled, its gross income increasing from about $80,000.00 to more than $187,000.00 in 1928. [Tr. 142, Petitioner's Exhibit One.]

(4) During the years immediately preceding 1929, the legal publishing business in Los Angeles became exceedingly competitive. [Tr. 60.] During this period, petitioner conducted approximately two-thirds of the legal publishing business in the Los Angeles area, but had several important competitors, including The Los Angeles News, The California Independent, The Los Angeles Review, and The Greater Los Angeles. Of the legal periodicals just mentioned, the Los Angeles News was second in importance to petitioner. [Tr. 60.]

(5) In 1929, the owner of the legal publishing company which owned The Los Angeles News, The Greater Los Angeles and a one-fourth interest in The California Independent approached petitioner and suggested a consolidation of the legal newspapers operating in the Los Angeles area. [Tr. 60.] After careful consideration by petitioner's stockholders and directors, a plan of consolidation was agreed to. [Tr. 61, 67.]

The consolidation plan contemplated the formation of a new corporation which was to acquire the publishing business of the various independent companies.

Said consolidation agreements appear in full in the transcript of record, pages 111-138. For the further information of the Court, the application filed on behalf of the new company with the California Corporation Commissioner for a Permit to issue and sell its stock appears in the transcript, pages 91-104. The consolidation plan as set forth in the agreements and petition just referred to was duly consummated. [Tr. 61-63.]

(6) The new company heretofore referred to was called "Consolidated Printing and Publishing Company." [Tr. 60.] Its Class A preferred stock was issued to the various periodicals heretofore referred to for tangible assets. Its Class B preferred and common stock was issued to said persons for subscription lists, good will and other intangibles. [Tr. 62-63 and 91-94.] Petitioner received 69% of the Class A preferred stock, 65% of Class B preferred, and 67% of the common stock. [Tr. 34.]

(7) Among others, the consolidation and the agreement providing therefor contained the following important features and provisions:

(a) The component companies, including petitioner, specifically agreed to render all possible aid to the new enterprise the consolidation agreement in this particular providing in part [Tr. 118]:

> "It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by this agreement will use their best efforts and endeavors to further and promote the business of said new corporation."

(b) It was specifically understood and agreed by all the parties that the new enterprise was to be managed by petitioner, acting through its president, Douglas W. Wilson. [Tr. 66, 88-90.] Had this not been agreed to, the consolidation would not have been effected. [Tr. 90.]

(c) Consistent with the intent of the parties as heretofore set forth, it was specifically agreed that the new enterprise would pay no salary to any officer without the consent of all the directors. [Tr. 115, 129, 134, 65.] In this connection, the agreement provided in part [Tr. 115]:

> "It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation."

(d) The various component enterprises acquired by the new corporation were operated as separate departments. [Tr. 73.] The various legal publications were not published under the name of Consolidated Printing and Publishing Company, but under their prior names. Consolidated Printing and Publishing Company is not known to the public; its name does not appear any place in the offices or plants of the enterprise; and it is not even listed in any Los Angeles Telephone Directory. It has no letterhead or billhead. [Tr. 71-73.]

At all times since the consolidation in 1929, petitioner's offices and plant have remained in the same location as prior to said consolidation. [Tr. 71.]

(8) Subsequent to the consolidation, the new enterprise has been managed by petitioner through the petitioner's president, Douglas W. Wilson. [Tr. 83.] For his services in these particulars, petitioner has paid to Wilson an annual salary of $12,000.00. [Tr. 58, 66.]

The management services of Wilson are stipulated by the parties to be worth not less than $12,000.00 a year. [Tr. 153-154.] In fact, they were reasonably worth $18,000.00 a year. [Tr. 75.]

The new enterprise, namely Consolidated Printing and Publishing Company, has never paid Wilson any salary. [Tr. 66, 67.]

(9) Since the consolidation, petitioner's business has been the management of Consolidated, and the former stockholders and directors have met regularly and frequently to discuss and determine the policies to be followed in the conduct of Consolidated's business. Douglas W. Wilson in acting as president of Consolidated has at all times been proceeding under the express instructions and at the express direction of petitioner's directors. [Tr. 70, 77, 81, 82, 84, 86, 87, 88.]

(10) The stock of Consolidated received by petitioner in 1929 constituted petitioner's principal asset. [Tr. 69-70, 144-145.]

During the years here under review [Tr. 36-38] the income from Consolidated stock was prac-

tically the sole source of petitioner's income. During 1936, 1937 and 1938, income from sources other than Consolidated stock totaled 2.7%, .35% and 1.04%, respectively of petitioner's gross income. [Tr. 143, Petitioner's Exhibit Two.]

Since petitioner's business was the management of Consolidated and petitioner's principal asset and income came from Consolidated, petitioner's president, Douglas W. Wilson, devoted substantially all his time to the management of Consolidated. [Tr. 69.]

(11) Petitioner was not a mere investor in the stock of Consolidated, instead it was actively engaged in the management of said corporation. Upon cross-examination by counsel for respondent, Mr. Wilson testified in part as follows [Tr. 86, 87]:

> "Q. The actual work and services performed by you in connection with the holding of the assets of the Daily Journal Company and the management thereof did not consume a great deal of your time, did it?
>
> A. The assets of the old Journal?
>
> Q. Of the Daily Journal Company, which it owned, during the years 1936, 1937 and 1938?
>
> A. Other than the stock in the Consolidated?
>
> Q. I mean all of the assets.
>
> A. Oh, yes. It consumed all my time, including the stock of the Consolidated. That is our sole interest and practically the only asset we have is our stock in the Consolidated.
>
> Q. All you have to do is to hold the stock, don't you? [101]
>
> A. If you didn't manage the Consolidated properly, the Journal wouldn't have anything.

Q. But the fact is you weren't required to do that, were you?

A. Oh, definitely, by the stockholders of the Daily Journal Company. That is our sole interest. We have no other interest.

Q. Suppose you just sat by and collected the dividends, what would happen?

A. I don't think there would be any dividends, if we just sat by.

Q. But you could do it, if you just so chose?

A. I don't see how we could collect the dividends. I don't believe there would be any.

Q. The actual legal imposition of duties upon you was merely to hold the assets; isn't that correct?

A. No.

Mr. Latham: Just a minute. Will you read the quesiton? I believe he has answered that a number of times, Mr. Tonjes.

Will you read the question?

(The question and answer were read.)

Mr. Latham: Oh, I have no objection.

Q. By Mr. Tonjes: Was the answer 'no'?

A. Yes.

Q. What else did you have to do?

A. To continue making a profit with those assets by [102] managing the Consolidated for the Daily Journal stockholders. That is the only source of income they have, and if not properly managed, would not be worth anything, and being a specialized business, I don't believe you could save those assets if they were mismanaged.

Q. Now, the $12,000 salary which you received during the years, 1936, 1937 and 1938, was authorized by the board of directors in 1917?

A. Yes.

Q. In 1917 was the Daily Journal Company operating a newspaper?

A. Yes.

Q. And the corporation was then engaged in active business?

A. *Yes, the same as now.*" (Italics supplied.)

(12) During the years 1937 and 1938, petitioner pursuant to a consistent policy paid to its stockholders all the earnings received by it from Consolidated after deducting operating expenses. [Tr. 76.] Its earned surplus balances at the end of the years 1936, 1937 and 1938 were $892.94, $558.41 and $504.53, respectively. [Tr. 144.]

(13) Petitioner's 1937 gross income was $40,851.75. [Tr. 142.] After paying the $12,000.00 salary to Mr. Wilson, together with other operating expenses, petitioner paid out as dividends $29,000.00. [Tr. 144.] In 1938, petitioner's gross income amounted to $26,772.51. After paying to Mr. Wilson his salary of $12,000.00, together with other operating expenses, petitioner distributed dividends of $13,540.00 [Tr. 144.]

(14) Respondent disallowed as a deduction in determining petitioner's net income for the calendar year 1936, 1937 and 1938, $10,000.00 of the $12,000.00 salary paid petitioner to its president, Douglas W. Wilson. Substantially all the tax deficiencies here in controversy result from such action.

In addition, respondent determined personal holding company surtaxes against petitioner for the years 1937 and 1938 on the theory that it had not distributed its net income to its stockholders. This action

was taken in spite of the fact that as heretofore shown it distributed all its income for said years either as salaries or dividends.

The Tax Court sustained respondent in the particulars specified. Its decision was apparently based on some theory that petitioner was endeavoring to improperly disregard corporate entities. [Tr. 44, 45.] This petition for review followed.

Specification of Errors.

[Tr. 154.]

(1) The Tax Court erred in failing to find or conclude that during the years 1936, 1937 and 1938 petitioner was carrying on the business of managing and operating Consolidated Printing and Publishing Company.

(2) The Tax Court erred in failing to find that the $12,000.00 annual salary paid by petitioner to Douglas W. Wilson during each of the years 1936, 1937 and 1938 was a reasonable and necessary business expense within the meaning of the language of Section 23(a) (1) of the Revenue Acts of 1936 and 1938 and was deductible in determining petitioner's taxable net income for said years.

(3) The Tax Court erred in failing to enter a decision for petitioner finding that petitioner neither was subject to any income tax deficiencies for the years 1936, 1937 or 1938, nor was subject to any personal holding company surtax deficiencies for the years 1937 or 1938.

(4) The Tax Court erred in entering decision for respondent.

Petitioner's Contentions and Summary of Argument.

Petitioner contends:

(1) That the issue presented to this Court for review is not one of primary fact but rather is a question of ultimate fact, and may, therefore, be considered by this Court without regard to the ruling of the Tax Court.

(2) That the deductibility of items of expense paid by a stockholder of a corporation is dependent upon whether or not said stockholder occupies merely the role of a passive investor or is so actively engaged in the conduct of the enterprise that it constitutes said stockholder's business.

That if the stockholder is merely a passive investor, said items are not deductible. If he is doing more than merely what is necessary from an investment point of view, the contrary is true.

(3) That petitioner during the taxable years in controversy was in fact and law engaged in active business, namely, the management of Consolidated Printing and Publishing Company.

(4) That said active business could only be carried on by petitioner through its officers and employees of whom its present president, Douglas W. Wilson, was obviously one.

(5) That since petitioner was engaged in active business during the years under review, amounts paid by it to its president, in connection with the carrying on of its business, obviously constituted ordinary and necessary expenses and are obviously deductible in determining taxable net income.

(6) That the Tax Court, in denying the deduction claimed, admits that the question of reasonableness is not involved. Instead, it confused the issue by assuming that petitioner was seeking to disregard corporate entities.

(7) That the authorities cited by the Tax Court in its memorandum opinion are not in point as they all involved instances of passive investors. None of them involved cases of active business enterprises.

(8) That in the case at bar, petitioner actually distributed all its earnings either by way of salaries or dividends. The salaries paid by petitioner to its president cannot be recovered by petitioner and restored to surplus even though a portion thereof is disallowed as a deductible expense.

That the personal holding company surtax is a penalty tax intended to be asserted only where earnings have not in fact been distributed. It was never intended to be asserted in cases such as this where all earnings have in fact been paid out.

Outline of Argument.

A. The questions here presented may be considered by this court without regard to the findings of the tax court.

B. Items of expense paid by a stockholder in connection with the affairs of a corporation in which it owns stock are deductible if the stockholder's interest in said corporation is so active as to constitute its business.

C. The tax court clearly erred in disallowing as a deduction the $12,000.00 salary paid by petitioner to its president during the years in question.

D. Regardless of the deductibility of the salary claimed, the tax court erred in asserting personal holding company surtaxes against petitioner for the years 1937 and 1938.

Argument.

A. The Questions Here Presented May be Considered by This Court Without Regard to the Findings of the Tax Court.

We are clearly not here concerned with findings of primary fact. Accordingly, the Tax Court's conclusions are obviously not binding here.

The Tax Court's disallowance of the salary deduction claimed is not based on any theory that it is unreasonable in fact. The record shows that the services rendered by Mr. Wilson were eminently worth the $12,000.00 claimed. It apparently is the Tax Court's and Respondent's contention, however, that said salary should have been paid by Consolidated Printing and Publishing Company. This involves the finding that petitioner was not in fact engaged in the operation and management of Consolidated, or, in other words, that petitioner's regular business was not the operation of Consolidated.

It is clear that the Tax Court's finding involved conclusions of law or at least the determination of a mixed question of law and fact. With respect to such issues, the Appellate Court is free to reach its own conclusion entirely independent of the finding of the Court below.

This precise situation was considered by the 7th Circuit Court in the recent case of *Marsch v. Commissioner,* 110 Fed. (2d) 423 (C. C. A. 7th, 1940). In that case the Tax Court denied to taxpayer a deduction for a loss sustained in connection with the operation of a racing stable, basing

its denial on the conclusion that petitioner was not engaged in business. Upon review, the Circuit Court reversed the Tax Court and said with respect to the latter's conclusions:

> "The words 'business regularly carried on by the taxpayer' are not defined by the statute. In such a case the findings of the Board are not conclusive and where the ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact, it is subject to judicial review * * * (citations) * * * and it becomes the duty of the Court to decide whether or not the correct rule of law has been applied to the facts found."

See also *Helvering v. Tex-Penn Oil Co.,* 300 U. S. 481, 57 S. Ct. 569 (1939).

As a matter of fact, we do not feel that any claim has or will be made by respondent that the issues involved in this proceeding are not subject to full review by this Court.

B. Items of Expense Paid by a Stockholder in Connection With the Affairs of a Corporation in Which It Owns Stock Are Deductible If the Stockholder's Interest in Said Corporation Is so Active as to Constitute Its Business.

We are here concerned with the difference between a passive investor and one whose interest is so active as to amount to the conduct of a business. If the expenditure is connected with a trade or business, it is clearly deductible. If not, the contrary is true.

This principle was established by the leading case of *Foss v. Commissioner,* 75 Fed. (2d) 323 (C. C. A. 1st, 1935). There the taxpayer owned a majority stock interest in the American Blower Co. and had substantial investments in the B. F. Sturtevant Co. A minority stockholder of Blower Company filed suit charging taxpayer with waste of the company's assets, etc. The taxpayer incurred attorneys' fees and other expenses in connection with said litigation which he deducted as ordinary and necessary business expenses under provisions of prior revenue acts identical with those covering the years here under review.

The Commissioner disallowed said deductions and was sustained by the Tax Court. In reversing the Tax Court, the 2nd Circuit Court said, page 328:

> "The line comes between those who take the position of passive investors doing only what is necessary from an investment point of view and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business."

This principle has been clearly recognized and followed by the Courts.

Helvering v. Highland, exec., 124 F. (2d) 556 (C. C. A. 4th, 1942);

Kane v. Commissioner, 100 F. (2d) 382, C. C. A. 2d, 1938;

Marsch v. Commissioner, supra;

See:

Stephen Hexter v. Commissioner, 47 B. T. A. No. 69 (1942).

This line of distinction has been recognized by the Supreme Court.

See:

Higgins v. Commissioner, 312 U. S. 212, 217, 61 S. Ct. 475, 478 (1941).

The *Highland* case, *supra,* is especially worthy of careful consideration. There the decedent left a substantial estate which included the capital stock of several land companies and a majority of the Class A common stock in the Clarksburg Publishing Company which published two papers. The decedent by his will authorized the executors to carry on any business or financial affairs in which the decedent might be interested at the time of his death "as fully and to the same extent as I could or might do if still living." Decedent's executor became president of the Clarksburg Publishing Company and had directed the policies of the newspapers published by said corporation. Said executor devoted practically all his time to the management of the real estate companies and the Clarksburg Publishing Company. Dividends received from the Clarksburg Publishing Company constituted a substantial part of the estate's income.

The estate became involved in litigation with respect to its interest in the Clarksburg Publishing Company and certain of the land companies, etc. It incurred other expenses with respect to claims against the estate, office expenses, etc. These various items were claimed as deductions by the estate in determining its gross income during the years under review. All were disallowed by the Commissioner. The tax Court reversed the Commissioner with respect to certain of said deductions and in particular allowed those pertaining to the management of the Clarksburg Publishing Company and various land companies. The Commissioner petitioned the Circuit Court for review.

The Court in affirming the decision of the Tax Court cited with approval the *Foss* case, *supra*, and said:

> "* * * clearly the taxpayer was not in the role of a passive investor, a mere conservator of property or a normal liquidator of an estate * * *
>
> "Rather we believe that the estate, by virtue of its holdings in several real estate companies, was actively engaged in the real estate business and even more actively in the newspaper business. All of the evidentiary factors which we have previously mentioned in this opinion point to such a conclusion.
>
> "We agree with the Board that the suits involved in this case were connected with the carrying on of the business of the estate and not with its mere conservation or liquidation * * *"

It would be difficult to find a case more squarely in point here than the one just referred to. In connection therewith the following should be noted:

> (1) The net income of the estate in the *Highland* case was computed in exactly the same fashion, so

far as expenses are concerned, as that of petitioner herein, and as the net income of an individual would be computed.

(2) The estate in carrying on the publishing business as a stockholder of a corporation could act only through the estate's executor. In the instant case, petitioner in carrying on the business of Consolidated could only act through its president to whom it paid a salary.

(3) If the *Highland* estate was carrying on the publishing business under the facts heretofore specified, petitioner herein was clearly carrying on the same type of business in conducting the affairs of Consolidated Printing and Publishing Company.

This Court has itself specifically recognized the test of "Is the taxpayer doing only what is necessary from an investment point of view?"

> *Miller v. Commissioner,* 102 Fed. (2d) 476 (C. C. A. 9th, 1939).

There this Court cited the *Foss* case, *supra,* as authority for the following statement:

> "The Courts have held that where a man takes an active part in the management of an enterprise in which he has investments, his activities amount to the carrying on of a trade or a business, but they have drawn the line between such cases and those where the activities of the party are merely looking after investments and doing only what is necessary from an investment point of view."

C. The Tax Court Clearly Erred in Disallowing as a Deduction the $12,000.00 Salary Paid by Petitioner to Its President During the Years in Question.

(1) Petitioner was not a passive investor so far as Consolidated was concerned. but was engaged in active business and said business consisted of the management of Consolidated.

The Tax Court in its memorandum opinion said [Tr. 44]:

> "* * * we cannot agree with petitioner's view that its business was that of operation and management of Consolidated,"

but assigned no reason for its conclusion in this regard. With all due respect to the Tax Court, we submit that its finding is clearly erroneous and totally without basis in fact or law.

Every fact and circumstance here involved indicates that the sole business of petitioner was the management and operation of Consolidated. The original Consolidation agreement, heretofore referred to, specifically required petitioner to devote its best efforts to the furtherance of Consolidated's business. [Tr. 118.] It was at all times specifically contemplated that petitioner would operate Consolidated through its president, Douglas W. Wilson. Petitioner's stockholders and directors directed Wilson to become president of Consolidated and to operate Consolidated. *This was the only way by which petitioner could carry out its contractual obligations.*

The testimony of Mr. Wilson printed in full in the transcript, pages 63 to 90, is conclusive with respect

to the matters here in controversy. Should there be any doubt that petitioner's business was the management of Consolidated, we respectfully suggest that the Court read said testimony in full.

It would be difficult to conceive of a clearer example of the conduct of an active business than that here involved. The facts of this case, it is submitted, fall squarely within those involved in the case of *Helvering v. Highland, supra.* All that was said there is applicable here.

(2) The Tax Court confused the issue here involved.

The Tax Court's memorandum opinion [Tr. 44 to 46] indicates that it did not grasp the real issue, namely, whether we were here concerned with the case of a passive investor or the active conduct of a business.

Apparently the Tax Court thought that petitioner was asking it to disregard corporate entities. This is indicated by the following excerpts from the Tax Court's memorandum opinion.

> "The circumstances and facts disclosed by the record, in our opinion—and we so hold and determine—show that the petitioner and Consolidated are distinct and separate corporate entities and that they are such may not be disregarded or ignored. * * *" [Tr. 44.]

Again the Tax Court said in its opinion:

> "A clear statement of the law touching the setting aside or disregard of corporate entities and citation of numerous authorities bearing on the subject are given in Inland Development Co.

v. Commissioner, 120 Fed. (2d) 986 (C. C. A. 10), decided in June, 1941." [Tr. 45.]

It is perfectly obvious that petitioner is not and never did contend that corporate entities should be disregarded. It has never even been remotely suggested that such procedure should be followed. The Tax Court has apparently misconceived the real issue.

(3) The authorities cited by the Tax Court in its memorandum opinion are not in point.

In this connection the Tax Court said in its opinion [Tr. 43],

> "That the $12,000.00 salary payment by petitioner * * * in each of the taxable years * * * was not an ordinary expense of petitioner in the carrying on of its business * * * is virtually conceded by petitioner's counsel, who at the hearing herein, in part, stated: 'With regard to the salary issue, I might add that this is not the ordinary salary case by any manner or means. I know of no case on the books that is any where close to the issue that we have.' "

The Court's observation in this respect was obviously unjustified. Its irrelevance must be clear. By said remark counsel only intended to make it clear that we were not dealing with a fact case in which an *unreasonable* salary was involved.

It is unnecessary to here review all the authorities referred to by the Tax Court in its opinion. We trust it will be sufficient to say that counsel for petitioner has read them all with care. We respectfully assert that not one is in point. Our views in this

particular may be best illustrated by examining the first authority referred to by the Tax Court, namely, the decision of said Tax Court in the case of *W. M. Ritter Lumber Co.*, 30 B. T. A. 231 at 272. There the taxpayer corporation sold certain of its products through an English Corporation. Said taxpayer paid certain employees of said English corporation a bonus and claimed the right to deduct said payments in determining taxable income. *The persons to whom said bonuses were paid were not employees of the taxpayer.* No claim was made that the business of the taxpayer consisted of the operation of the English corporation.

The Tax Court in denying the deduction claimed said:

> "Clearly such expenditures were purely gratuities and did not constitute deductible ordinary and necessary business expenses of the Ritter Co. * * *."

It would be difficult to find a case less in point than the one just cited. Its use by the Tax Court as an authority for its decision in the case at bar is further proof of the fact that the Tax Court totally failed to understand the real issue under consideration.

D. Regardless of the Deductibility of the Salary Claimed, the Tax Court Erred in Asserting Personal Holding Company Surtaxes Against Petitioner for the Years 1937 and 1938.

The respondent, as a result of disallowing $10,000.00 of the $12,000.00 salary claimed as a deduction in each year, increased taxable income by said amount disallowed. It then found that said income had not been distributed. and imposed the highly punitive personal holding company surtax which amounts to sixty-five and seventy-five per cent in addition to the regular income tax on the amounts disallowed. This action was taken in spite of the obvious fact that the corporation had *actually* distributed all its earnings during the years under review. As heretofore pointed out in the statement of facts, the petitioner's records show that it accumulated no earned surplus during the years under consideration. Even if respondent was right in disallowing the salary claimed, it could not be recovered from petitioner's president who has, himself, paid a tax thereon. Accordingly, under no circumstances could petitioner obtain any surplus out of which the $10,000.00 disallowed each year could possibly be distributed.

All these facts are crystal clear. Nevertheless, respondent proposes to assert personal holding company surtaxes for 1937 and 1938 in the amount of $15,255.36. A more inequitable result where a taxpayer has obviously acted in good faith could scarcely be imagined.

The personal holding company surtax was obviously intended to be asserted only where earnings were not distributed. It was never intended to be asserted in situations such as the present.

The courts have the power and duty to declare that a thing presumably within the letter of a statute is nevertheless not subject thereto because not within its spirit or the intention of its makers. This power has been used by the courts to prevent abuse of statutory provisions by taxpayers, see

> *Gregory v. Helvering,* 293 U. S. 465, 55 S. Ct. 266 (1939),

and to prevent an unjust and unintended application of the taxing statute.

> *Pembroke Realty & Securities Corporation v. Commissioner,* 122 F. (2d) 252 (C. C. A. 2nd, 1941).

In the last named case a corporation with its capital impaired and accordingly unable to pay out dividends had a large gain in its taxable year. Shortly before the end of the taxable year the assets of the corporation were distributed in complete liquidation, the corporation reserving only sufficient cash to pay the normal income taxes and cost of liquidation. The Commissioner assessed a personal holding company surtax deficiency on the ground that none of the income was distributed. Without question this situation came within the precise language of the personal holding companies surtax statute. The Tax Court sustained the Commissioner. The Second Circuit Court

reversed the Tax Court's decision. The Court explained the broad ground upon which it rested its decision in the following language:

> "It is within the power of the courts to declare that a thing which is within the letter of the statute is not governed by the statute because not within its spirit or the intention of its makers (citations). We think this principle justifies the holding that Pembroke, which distributed all of its current income in complete liquidation, was not subject to the surtax provided by Section 351."

This principle that a statute should not be applied where the particular situation is without doubt outside the spirit of the statute and the intention of the legislators and where the inclusion of the particular situation within the statute would lead to a gross injustice is not a new principle of law. Instead it is a general rule which has been long recognized by our Supreme Court.

Lau Ow Bew v. United States, 144 U. S. 47, 12 S. Ct. 517 (1892);

Rector, etc. of Holy Trinity Church v. United States, 143 U. S. 457, 12 S. Ct. 511 (1892).

Petitioner respectfully submits that if there was ever a case in which this equitable power should be invoked it is the present case, and that irrespective of the ruling of the Tax Court with respect to the salary deduction, it should not be liable for personal holding company surtaxes for the years 1937 and 1938 on any amount.

Conclusion.

In conclusion, petitioner respectfully submits:

(1) That the salary paid its president during the years 1936, 1937 and 1938 is properly deductible in determining petitioner's taxable net income.

(2) That is no event should personal holding company surtaxes be asserted against petitioner for the years 1937 and 1938.

Respectfully submitted,

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